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October 18, 2021

Via email: regs.comments@federalreserve.gov

Board of Governors of the Federal Reserve System,
20th Street and Constitution Avenue,
NW, Washington,
DC 20551
regs.comments@federalreserve.gov

Re: Proposed Interagency Guidance on Third-Party Relationships: Risk Management

Dear Sir/Madam,

CLS Bank International (“CLS”) welcomes the opportunity to respond to the “Proposed Interagency Guidance on Third-Party Relationships: Risk Management” (the “Guidance”), issued jointly by The Board of Governors of the Federal Reserve System (“FR Board”), the Federal Deposit Insurance Corporation (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”), together the “Agencies”.

Background

CLS was established by the private sector, in cooperation with a number of central banks, to mitigate the settlement risk (loss of principal) associated with the settlement of payments relating to foreign exchange transactions. CLS operates the world’s largest multicurrency cash settlement system (the “CLS system”) and provides payment-versus-payment (“PvP”) settlement in 18 currencies directly to over 70 members, some of which provide access to the CLS system for over 25,000 third-party institutions.

As an Edge Act corporation established under Section 25A of the Federal Reserve Act, CLS is regulated and supervised by the FR Board and the Federal Reserve Bank of New York (“FRBNY”) (collectively, the “Federal Reserve”). Additionally, the central banks whose currencies are settled in the CLS system have established the CLS Oversight Committee, organized and administered by the Federal Reserve pursuant to the *Protocol for the Cooperative Oversight Arrangement of CLS*,¹ as a mechanism to carry out the central banks’ individual responsibilities to promote safety, efficiency, and stability in the local markets and payments systems in which CLS participates.

As a systemically important financial market infrastructure (“FMI”), CLS is subject to the CPMI-IOSCO *Principles for financial market infrastructures* (the “PFMI”), as applicable to payment systems. In addition, CLS was designated a systemically important financial market utility (“DFMU”) by the Financial Stability Oversight Council in July 2012 under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The FRBNY conducts day-to-day supervision of CLS, as delegated by the FR Board and CLS is subject to the risk management standards set forth in Regulation HH.

¹ https://www.federalreserve.gov/paymentsystems/cls_protocol.htm.

General Comments on the Proposal

CLS broadly supports the Guidance including the general scope and coverage set out in the Guidance. CLS has reviewed the Guidance from two perspectives: (i) as a procurer of third-party services (some of which are critical to the services provided by CLS to the market as an FMI); and (ii) as a provider of services to the market, in our role as an FMI, therefore assessing the applicability of the Guidance to us as an FMI providing services to our participants. In consideration of both perspectives, we request that the following important considerations are taken into account.

CLS recommends that the Agencies establish a clear definition of 'third-party relationships.' Within that definition, activities undertaken by FMIs, for example settlement activities, should not be within scope of the definition to ensure consistent application of the Guidance with respect to engagements between banking organizations and FMIs. CLS considers it to be of particular importance to exclude activities undertaken by FMIs from the definition of third-party relationships as it is often impracticable for FMIs to satisfy certain key requirements of the Guidance at the behest of individual banking organizations, that may deem the FMI's services to be a critical third-party relationship, (e.g., negotiating and amending FMI-banking organization contractual arrangements that by their nature generally cannot be negotiated or amended on an ad hoc or bilateral basis).

There is already consideration in the regulatory sphere that services provided by FMIs are unique and quite divergent from traditional third-party relationships. For example, this has been acknowledged internationally by the Financial Stability Board ("FSB") with respect to resolution and recovery planning for banking organizations.² CLS would encourage the Agencies to also take such consideration into account when finalizing the Guidance.

Further, because FMIs are already subject to specific regulatory regimes, CLS strongly suggests that these FMI specific regulatory regimes are utilized for the oversight of the FMI in their capacity of providers of third-party services, rather than apply separate, potentially divergent standards through the implementation of the Guidance by individual banking organizations.³ In summary, there is a risk that the banking organization's inability to implement the requirements in the Guidance with FMIs (for example, with respect to switching providers or continuity of access requirements) may ultimately dissuade banking organizations from utilizing important risk reduction and liquidity optimization services – to the detriment of global financial markets.

In addition to the above, CLS has provided specific comments, as outlined below, in areas of the Proposal where it believes it can provide useful input.

Specific Comments on the Proposal

Q1: To what extent does the guidance provide sufficient utility, relevance, comprehensiveness, and clarity for banking organizations with different risk profiles and organizational structures? In what areas should the level of detail be increased or reduced? In particular, to what extent is the level of detail in the guidance's examples helpful for banking organizations as they design and evaluate their third-party risk management practices?

CLS strongly supports the use of a risk-based and proportionate approach to third-party risk management and welcomes greater detail on this concept in the Guidance, as this will allow banking organizations looking to implement this Guidance to narrow their focus in accordance with the degree of materiality of

² See, for example, "[Guidance on Continuity of Access to Financial Market Infrastructures \(FMIs\) for a Firm in Resolution](#)"

³ See, for example, "[Principles for financial market infrastructures: Assessment methodology for the oversight expectations applicable to critical service providers \(bis.org\)](#)"

the third-party activity, and therefore allocate resources proportionately to the management of such arrangements. In particular, CLS recommends where the Guidance specifically applies to material and/or critical third-party relationships, this should be further emphasized and clarified.

Additionally, CLS notes that the definition of third-party relationships includes activities that involve outsourced products and services and therefore encourages the Agencies to consider whether outsourcing and material/ critical outsourcing should be further defined. For example, CLS notes that the definition of third-party relationships includes “services provided by affiliates and subsidiaries” and would recommend that it is made clear when detailing the benefits, risks and challenges of third-party relationships that the use of inter-group relationships are understood to present less risk to the entity (through greater ability to enforce controls) and proportionate application of the Guidance should be considered in this regards.

Q2: What other aspects of third-party relationships, if any, should the guidance consider?

As per the above comments, CLS recommends that the Guidance excludes FMIs from the definition of third-party relationship, when acting as a provider of third-party services to banking organizations within scope of this Guidance. For example, this approach was taken in the recently published European Banking Authority Guidelines on outsourcing arrangements,⁴ whereby a list of excluded activities is expressly provided, including: “clearing and settlement arrangements between clearing houses, central counterparties and settlement institutions and their members.”⁵

Q3: In what ways, if any, could the proposed description of third-party relationships be clearer?

As discussed in response to question 1, CLS notes that the definition of third-party relationships includes outsourcing and proposes that the Agencies consider whether material/critical outsourcing should be defined, for which certain elements of the Guidance should apply due to the activity’s material/critical nature, over and above that of a non-critical third-party relationship.

Q5: What changes or additional clarification, if any, would be helpful regarding the risks associated with engaging with foreign-based third parties?

Most complex third-party relationships are global and may also include the use of foreign-based sub-contractors. CLS suggests the Agencies outline in more detail the risks in relation to foreign-based third parties that this Guidance seeks to mitigate, to better assist banking organizations with their application of the Guidance. For example with regards to foreign-based third parties, the European Banking Authority Guidelines on outsourcing arrangements references the need to take into account differences in national provisions regarding the protection of data, in that agreements with third parties should ensure that the service provider protects confidential, personal or otherwise sensitive information and complies with all legal requirements regarding the protection of data that apply to the institution or payment institution.⁶

⁴ European Banking Authority. *EBA Guidelines on Outsourcing Arrangements*, EBA/GL/2019/02, 25 February 2019.

⁵ European Banking Authority. *EBA Guidelines on Outsourcing Arrangements*, EBA/GL/2019/02, 25 February 2019, p.26.

⁶ European Banking Authority. *EBA Guidelines on Outsourcing Arrangements*, EBA/GL/2019/02, 25 February 2019, p. 47.

Q6: How could the proposed guidance better help a banking organization appropriately scale its third-party risk management practices?

CLS proposes that consideration is given to including within the definition of significant bank functions, activities that not only cause financial loss but also those that may cause severe operational disruption and therefore lead to business continuity issues and have an impact on the internal control environment of an entity. CLS also proposes that the Agencies consider merging the definitions of 'critical activities' and 'significant bank functions' to avoid any unnecessary confusion between the terms.

Additionally, CLS notes the Guidance proposes additional risk considerations in relation to strategy and planning regarding evaluation of indirect costs, impact on strategy and projects, and impact on resourcing. CLS proposes that there is further clarification on the applicability of these considerations in relation to the criticality of third-party relationships to allow banking organizations to focus resources accordingly.

Q7: In what ways, if any, could the proposed guidance be revised to better address challenges a banking organization may face in negotiating some third-party contracts?

With respect to negotiating third-party contracts, CLS suggests further clarification to be provided as to which specific areas of the Guidance relating to contract requirements are applicable only for contracts relating to critical activities and engagements i.e. which areas of the Guidance are not applicable to low risk engagements, thus allowing the banking organization to appropriately allocate resources to contract negotiation.

In addition, CLS suggests that the Guidance provides flexibility for the manner in which due diligence and/or audit requirements outlined in contracts are satisfied, for example in light of the COVID-19 pandemic companies will need to re-consider how they contract for due diligence activities and/or audits of third parties, and are likely to wish to minimize the need for on-site visits, and therefore may not follow the suggested Guidance regarding on-site visits.

Q8: In what ways could the proposed description of critical activities be clarified or improved?

As described above, CLS agrees with and encourages the use of a risk-based approach when applying this Guidance and suggests that further clarification is provided around what is considered a 'critical activity', which excludes the services provided by FMIs.

Q9: What additional information, if any, could the proposed guidance provide for banking organizations to consider when managing risks related to different types of business arrangements with third parties?

CLS would welcome further clarity regarding what constitutes a concentration risk and appropriate mitigants for engagements with service providers who provide services to multiple banking organizations. It may be difficult for an individual banking organization to determine whether there is market wide concentration risk, and this area may be one better managed on a systemic basis rather than at the individual banking organization level. In addition, FMIs by their nature, may be considered by an individual banking organization to represent a concentration of service provision and therefore CLS suggests it could be emphasized in the Guidance that FMIs are monitored under their separate existing regulatory regimes, and do not need to be taken into consideration of risk management activity under the Guidance.

Q14. In what ways, if any, could the proposed guidance further address due diligence options, including those that may be more cost effective? In what ways, if any, could the proposed guidance provide better clarity to banking organizations conducting due diligence, including working with utilities, consortiums, or standard-setting organizations?

CLS suggests that the Agencies encourage and allow for in the Guidance, the use of standard certifications for due diligence and audit purposes in more areas to promote efficiency and consistency in due diligence activity.

Q15. How could the proposed guidance be enhanced to provide more clarity on conducting due diligence for subcontractor relationships? To what extent would changing the terms used in explaining matters involving subcontractors (for example, fourth parties) enhance the understandability and effectiveness of this proposed guidance? What other practices or principles regarding subcontractors should be addressed in the proposed guidance?

CLS strongly suggests clarification on the applicability of the Guidance to subcontractors/fourth parties, including outlining which parts of the Guidance applies to subcontractors/fourth parties based on criticality, and the extent to which the application of the Guidance may differ in scope for subcontractors/fourth parties.

Q18. To what extent should the concepts discussed in the OCC's 2020 FAQs be incorporated into the guidance? What would be the best way to incorporate the concepts?

CLS found the OCC's 2020 FAQs to be helpful in providing more specificity and addressing specific industry issues and supports the inclusion of such specificity into the Guidance. In particular, the following concepts were most useful:

1. FAQ response 2: the further detail provided as to what constitutes a business arrangement is particularly helpful, especially the list of example categories used. The added examples of "vendors" and "outsource" were also particularly helpful as this terminology (and associated definitions) are more widely used and understood within banking organizations. CLS suggests that consolidated terminology is used by the Agencies to describe the relevant relationships to which the Guidance applies.
2. FAQ response 3: CLS welcomes further clarity with respect to the application of the Guidance to cloud service providers in particular with respect to whether the use of cloud service providers is considered to be a "critical activity." CLS strongly supports the statement that "the level of due diligence should be commensurate with the risk associated with the activity" and welcomes further specificity in the Guidance as to which risk components are more likely to indicate that an activity is a "critical activity".
3. FAQ response 5: the FAQs acknowledgement that not all entities have the ability to conduct extensive negotiation of contracts and/or to gather extensive information for due diligence purposes for all third-party relationships is particularly important. Also, CLS welcomes flexibility in the Guidance with respect to how banking organizations may determine that risks have been mitigated via due diligence or contract negotiation, recognizing that not all contractual relationships may be extensively negotiated and yet may still meet the needs of the banking organization.

4. FAQ response 7: CLS supports the concept that “not all third-party relationships present the same level of risks” and supports as much specificity as possible in the Guidance as to the degree to which the concepts in the Guidance should be applied to lower or higher risk activities.
5. FAQ response 14: the concept of standardized reports for the purposes of due diligence and audit activities is fully supportive. Additionally, should the Agencies determine that FMI-provided services should remain in scope of the Guidance, CLS strongly supports the statement that the PFMI may be relied upon by banking organizations who have third party relationships with FMIs. Reliance upon PFMI disclosures greatly reduces the overhead experienced by FMIs in response to due diligence questionnaires while simultaneously providing a consistent approach for the due diligence of FMIs. However, for the reasons detailed above, CLS would strongly recommend that FMI activities and services provided to banking organizations be excluded from the definition of a third-party relationship and therefore be moved out of scope of the Guidance.

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CLS greatly appreciates the opportunity to submit these comments and remains available to discuss any of these comments in further detail, as needed.

Sincerely,



Michele M. Fleming
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CC: Gaynor Wood, General Counsel